Office of Chief Counsel
Internal Revenue Service
memorandum
CC:WR:RMD:DEN:TL-N-2358-99
RAVarra

date:

to: Case Manager, E:2:14
International Examination Manager, E:2:15
Rocky Mountain District, Denver

from: District Counsel, Rocky Mountain District, Denver

subject: **Request for Advisory Opinion**
Payment of Obligations Incurred in Connection with Refinancing
Taxpayer: [redacted]

We are writing in response to your transmittal dated July 19, 1999, requesting our advice regarding the deductibility of certain payments made by the taxpayer in connection with the acquisition of [redacted].

ISSUE

Whether payments by an acquiring corporate in a purchase under I.R.C. § 338 made to settle obligations referred to as "cash settlement options" previously incurred by the acquired corporation in connection with a debt refinancing can be currently deducted by the acquiring corporation as an ordinary and necessary business expense.

CONCLUSION

The payments cannot be currently deducted by the acquiring corporation. The obligations are liabilities of the acquired corporation. The amount paid by the acquiring corporation to satisfy this debt is part of the purchase price.

FACTS

A declining market in the [redacted] industry during [redacted] put [redacted] in poor financial position. [redacted] undertook a financial reorganization, including the refinancing of substantially all of its long-term debt and the issuance of additional equity securities.

On [redacted] [redacted] entered into a credit agreement with [redacted] as agent for itself and several other financial institutions. This agreement provided for the following loans to [redacted]:

1. A $[redacted], [redacted]-year senior secured debt at [redacted]% above the higher of i) federal funds plus [redacted]% or 2) the prime rate charged by [redacted]. Quarterly interest and principal payments were required, with additional principal payments due upon the sale of assets, sale of additional equity or debt securities, and from excess cash flow, as defined in the agreement;

2. A $[redacted], [redacted]-year senior subordinated unsecured debt at [redacted]%, with the principal due at maturity on [redacted] and

3. A [redacted]-year revolving credit facility of up to $[redacted] at prime plus [redacted]%, a portion of which was used for letters of credit. Advances under this agreement are limited to [redacted]% of eligible accounts receivable, [redacted]% of [redacted], and [redacted]% of [redacted] materials and finished goods inventories. As of [redacted], there was $[redacted] in letters of credit outstanding and credit of $[redacted] available under this agreement.

As part of the refinancing, [redacted] issued warrants to [redacted] to purchase [redacted] shares of [redacted]'s common stock ([redacted]% of the shares on a fully diluted basis) at $[redacted] per share. [redacted]'s financial statements indicated that [redacted] of these warrants had been exercised as of [redacted]. Additional warrants for the purchase of [redacted] [redacted] common stock at $[redacted] per share had also been issued in connection with other financing. The financial statements indicate that, as of [redacted], [redacted] of these other warrants had been exercised.

As part of the refinancing, [redacted] also agreed to pay [redacted] (an affiliate of [redacted] a cash amount equal to [redacted]% of the value of [redacted]'s preferred stock in excess of $[redacted]. This amount was payable, subject to acceleration under certain conditions, after [redacted] and before [redacted]. If loan agreements prohibited [redacted] from making these payments, the payment would be made in either common stock or debt instruments. To carry out this agreement, [redacted] issued [redacted] instruments referred to as "cash settlement options" to [redacted]. On [redacted],

[redacted] assigned the cash settlement options to [redacted].

[redacted] had [redacted] outstanding shares of preferred stock. The preferred shares were entitled to a cumulative dividend of $[redacted] per share. As of [redacted], the accumulated dividend due to the preferred shareholders was $[redacted] per share, or a total of $[redacted]. After [redacted], the preferred shares were redeemable by the company for $[redacted] per share, plus unpaid dividends.

[redacted]'s books and records did not assign any liability for the warrants issued in conjunction with its financing activities. Notes to the [redacted] financial statement indicate that "[redacted]."

The cash settlement options were valued at $[redacted] and reported on [redacted]'s books as a liability and as an asset (loan costs). The loan costs were being amortized by [redacted] for financial reporting purposes. However, no amortization deduction was taken for tax purposes.

[redacted] paid off the [redacted] loan in [redacted] through a series of loans [redacted] received from the [redacted] ("the taxpayer").

In [redacted], the taxpayer acquired [redacted] in a transaction that qualified for treatment as an acquisition of assets under I.R.C. § 338. A valid election was made under I.R.C. § 338(g) to treat the acquisition as a purchase of the assets of [redacted] and allocate the purchase price to the acquired assets of [redacted]. [redacted] excluded the liability under the cash settlement options from the selling price in its gain computation. The taxpayer, likewise, excluded this liability in the computation of adjusted gross basis. This had no tax effect for [redacted], since net operating losses exceeded the selling price in any event. Exclusion of these liabilities, though, decreased the amount that would otherwise have been allocated to [redacted] assets by the taxpayer.

On [redacted], [redacted] called for redemption of the preferred shares. The redemption price was $[redacted] per share, which is the base price of $[redacted] per share plus accumulated, unpaid dividends of $[redacted] per share, for stockholders of record on [redacted].

On [redacted] the taxpayer, [redacted], and [redacted] entered into an agreement under which all rights under the cash options were relinquished in exchange for $[redacted].

The taxpayer made an M-1 adjustment on its [redacted] income tax return to deduct the $[redacted] payment for tax purposes, with $[redacted] called "stock appreciation rights" and $[redacted] called "premium".

ANALYSIS

In a transaction treated as an acquisition of assets under I.R.C. § 338, the target corporation is deemed to have sold its assets to a new corporation. I.R.C. § 338(a). The acquired corporation is deemed to have sold the assets as the "old target", and deemed to have been purchased the assets as the "new target". The deemed selling price is called the "adjusted deemed selling price" or "ADSP" and the deemed purchase price of the assets is called the "adjusted grossed-up basis" or "AGUB". The old target is required to recognize gain, based on the ADSP and the new target determines the basis of its assets by allocating the AGUB.

AGUB equals the sum of 1) the grossed up basis of the purchasing corporation's recently purchased target stock, 2) the basis of the purchasing corporation's nonrecently purchased target stock, 3) the targets liabilities, and 4) other relevant items. I.R.C. §§ 338(b)(1) and (2); Treas. Reg. § 1.388(b)-1(c)(1).

The liabilities of the target corporation included in AGUB are the liabilities of the new target corporation on the day immediately after the acquisition. Treas. Reg. § 1.338(b)-1(f)(1). Liabilities are included in AGUB only if they are bona fide liabilities, includible in basis under tax law principles. A liability is not initially included in AGUB if the amount of a contingent or speculative obligation is not includible in basis. Treas. Reg. § 1.338(b)-1(f)(2)(i). Amounts initially excluded from AGUB are taken into account to determine AGUB and the basis of the acquired assets based on tax law principles as if the new target had acquired the assets of the old target from an unrelated party and had assumed or taken the assets subject to the liability. Treas. Reg. § 1.338(b)-1(f)(2)(ii).

The phrase "other relevant items" included in the determination of AGUB includes only "adjustment events" that occur after the close of the new target first taxable year. Treas. Reg. § 1.338(b)-1(g)(1). One of the items included in the definition of "adjustment events" is old target liabilities that become determinable. Treas. Reg. § 1.338(b)-1(b).

In this case, [redacted] incurred a contingent obligation as part of its refinancing to pay an amount of cash in the future, represented by the cash settlement options. The actual amount that would have to be paid to satisfy this obligation was based on the future value of its preferred shares. [redacted] recognized this obligation on its books at an estimated value for accounting purposes. Because the obligation was contingent and speculative, this obligation was not recognized for tax purposes.

Normally, as part of the cost of obtaining financing, the cash settlement options would be capitalized and amortized over the life of the loan. Lay v. Commissioner, 69 T.C. 421 (1977). Because the cash settlement options were unpaid and the amount to be paid, if any, was contingent, no amount had been capitalized or amortized as of the date [redacted] was acquired by the taxpayer. [redacted]'s obligation remained a contingent obligation on that date and remained contingent obligations incurred by [redacted] until the cash settlement options were resolved by the agreement with the holder of that obligation in [redacted].

As a contingent liability, the cash settlement options were excluded from the determination of AGUB on the date of the deemed transaction under I.R.C. § 338. When the amount of the liability was finally resolved in [redacted], AGUB must be redetermined at that time. Under Treas. Reg. § 1.338(b)-1(f)(2)(ii), AGUB and the allocation of the purchase price to the acquired assets is adjusted when the liability is later determined. In addition, since the amount of the liability became determinable after the close of the new target corporation's first taxable year, the determination of the liability is an adjustment event under Treas. Reg. § 1.338(b)-1(b).

The Revenue Agent has indicated that the full amount of the additional AGUB resulting from the determination of this liability would be allocated to goodwill or going concern value. The taxpayer would be entitled to no amortization for this additional amount in [redacted] because the liability was contingent at the close of that tax year, and would be entitled to an amortization deduction for one month in [redacted] under I.R.C. § 197, because the amount of the liability did not become determinable until [redacted] of that year.

The taxpayer contends that it should be entitled to a current deduction of the full amount agreed to in resolution of the cash settlement options. The taxpayer has stated no basis for why this payment would be an ordinary and necessary business expense of [redacted] rather than an obligation of [redacted] that was deemed to have been acquired in the I.R.C. § 338 transaction. Based on the facts given, we are not aware of any legal basis to support such a position.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

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APPROVED:

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